## Reforming the Income Tax: A Citizen's Proposal

**By Richard A. Demers**

***"We cannot solve our problems
with the same thinking we used
when we created them."***
Albert Einstein.
*The Journal of Transpersonal Psychology, Volumes 1-4",
Transpersonal Institute, 1969, p. 124.*

### Introduction

The Federal income tax system in the United States is a complicated mess that intrudes in people's lives in too many ways and is no longer perceived as being fair. There are too many provisions favoring special interests of all kinds that deprive the government of the revenues needed to maintain essential services. Leaving aside all arguments about what constitutes essential services, and thus arguments about the proper size and role of government, this essay proposes a reformed income tax system that would finance the government in a way that is simple and fair. It is not the purpose of this proposal to increase or to cut anyone's taxes or to redistribute wealth, though these may well be side effects. Its only purpose is to equitably spread the cost of government over all individuals, businesses, and other organizations.

Is real tax reform possible? With real simplification? With real fairness? It is, if we accept the notion that good ideas from a variety of sources can be combined in a meaningful way for everyone's benefit. This proposal incorporates the **libertarian** ideas that government should intrude as little as possible in people's lives, that taxes should be kept as low as possible, and that people should have some say in how their money gets spent. It incorporates the **conservative** ideas that money that has already been taxed once shouldn't be taxed again through dividend, inheritance and gift taxes, and that government should not spend more than it takes in. And it incorporates the **liberal** ideas that we are a community and not just isolated individuals, that we all depend on the many services provided by that community, that those who receive more from our economy should contribute more, and that it is to everyone's benefit to help those in need.

The basic problem is that politicians try to make the tax system do too many things, to encourage or discourage various social policies, industries, or ideologies, and to buy votes from special interests; all such practices must be abolished. Politicians also use a variety of gimmicks to disguise expenses that they do not want to appear in budgets; all such "tax expenditures" must be outlawed. Recently, politicians have changed the tax laws so it appears they are anti-tax or even anti-government when nothing could be further from the truth. They have also attempted to create jobs or manipulate the economy by tinkering with taxes, generally without much benefit. They must be prevented from indulging in all of these bad habits.

The only purpose of taxation should be to raise money for government operations — nothing else. Our elected representatives must still be free to spend money however they think best, but at least the taxation side of the account books should be locked down, fair and understandable to everyone. Further, there must be a well-defined and automatic linkage between spending and taxation so that deficit spending cannot be a normal yearly occurrence, as it is today.

We need to get the tax man out of our personal and corporate lives. The tax system should interfere as little as possible with personal freedom and personal responsibility. We shouldn't have to live our lives with one eye always on tax consequences. Anyone who wants to invest in a business, buy a home, save for retirement, or contribute to a charity should do so because that is the right thing for them to do; not because it is the tax-efficient thing to do.

**Income**

Following the Supreme Court's lead, in this proposal all people, all business enterprises, and all non-profit organizations are considered individuals and they are all taxed in a uniform way — no special cases, not even for churches, charities, or political groups.

So, what should be counted as income? For persons, taxable income includes wages, tips, bonuses, awards, realized options, interest, dividends, pensions, Social Security payments, welfare payments, insurance and annuity pay outs, jury awards, alimony, lottery and gambling winnings, net business profits, gifts, and inheritances. And for businesses, it consists of gross receipts minus the costs of doing business, such as wages, materials, and services.

**Social Security and Medicare**

There should be no distinctions made between one kind of income and any other. If there is money coming in, it is income and it should be subject to taxation. Further, any taxation of income should be applied to all income; there should be no special purpose taxes that apply only to income from a particular source or limited to a specific range of incomes.

A gross unfairness, today, is that income from many sources, such as dividends and capital gains, are not subject to FICA and Medicare taxation. These wage taxes in 2011 were 4.2% for Social Security for wages up to $106,800 and 1.45% of all wages for Medicare, paid by both employee and employer. These taxes should be eliminated for both employees and their employers. In this proposal, the wage taxes currently paid by employees is simply returned to their take-home pay. Similarly, employer wage taxes are also eliminated. Taxation for Social Security (FICA) and Medicare is rolled into the general Federal income tax system.

Social Security and Medicare benefits are not a subject of this proposal; they are an obligation by the Federal government to pay benefits to people who have accumulated a certain number of credits and reached a certain age. These benefits should be paid to all eligible people, and everyone should be able to earn credits, based on the cumulative amount of income taxes they pay over their lifetime.

Let us be clear about one thing, Social Security and Medicare can never run out of money to pay benefits. The so-called Trust Funds are not annuities, they are a bookkeeping gimmick that should be abolished. Instead, benefits should be part of the Federal budget and paid out of current tax revenues, as they are anyway.

**Deductions**

***"We are all in the tax game together,
and what is a privilege to one group of people ends up
being a penalty to everyone else through higher tax rates."***
*Taxing Ourselves: A Citizen's Guide to the Debate Over Taxes*
by Joel Slemrod and Jon Bakija, 2008, p. 89.

We need to change the conversation about taxes away from all of the special privileges that people, businesses, and their lobbyists defend to the death, to something more like property taxes. If your house is worth X dollars, then your property tax is automatically Y dollars. For the most part, there are no special privileges attached to the property itself. The same approach needs to be taken for income taxes. If your total income is X dollars, your income tax should be a mathematical function of your income (tax = f (income) = Y dollars).

Thus, there should be no deductions, credits, allowances, exclusions, tax incentives, subsidies, or rebates to anyone for any purpose — none at all. In case what I mean by "no deductions" isn't clear, it means no medical expense deductions, no state and local tax deductions, no mortgage interest deductions no charity deductions, no gambling loss deductions, etc. "No exemptions" means no personal exemptions, no tax-exempt organizations, no interest or dividend exemptions, no exemptions for state and local bond interest, etc. "No credits" means no childcare credits, no blind credits, no education credits, etc. And "no allowances" means no moving allowances, no oil-depletion allowances, no equipment depreciations, no foreign havens to shelter income, or any other such corporate tax dodges.

This seems harsh, doesn't it? We are all so used to playing these tax-avoidance (and often tax-evasion) games that distort our economy. What everyone would get instead is a tax system that is simple, fair, and understandable.

### Income Transfers

#### Family Transfers

But what about families with six kids who need all those personal exemptions just to get by? A friend who is single argues that those exemptions aren't fair to him; why should a single person have to pay more because someone else chose to have kids? However, we all bear a certain amount of responsibility for each other, and certainly for all of our children; they are our national future. But there is also the basic idea that we should place high value on families (all families, however constituted) as the foundation of social stability. We need to recognize that families that raise children bear an extra financial burden for all of us.

So here is a change I would propose that would help families — without it being limited to only families. Every individual should be responsible for taxes on his own income. This means no more joint taxes on total family income. Mom, Dad, and each child should each pay taxes on their own income, from whatever source. This eliminates the so-called marriage penalty that results from progressive taxation of dual income families. It also means no tax rate differences for "Single," "Married filing jointly," "Married filing separately," or "Head of household" taxpayers.

By itself, this wouldn't make much difference to a sole-breadwinner family, but here is a second proposal. Any individual should be able to transfer any amount of his own income to any other individual, thereby lowering his own taxable income and the rate at which that income is taxed. (This assumes progressive tax rates, as discussed later in this essay.)

**Windfall Transfers**

What about large one-time income windfalls, such as inheritances, insurance pay outs, lottery winnings, and bonuses? In this proposal, income can be transferred to an individual's future years. This can be accomplished by investing the transferred income in a tax-deferred account similar to today's IRAs. This ability is not restricted to windfalls; current income can be transferred to later years for retirement or for other goals. Essentially the same rules regarding current Individual Retirement Accounts should apply. It should also be possible to withdraw funds without penalty from these accounts as current, taxable income.

**Corporate Transfers**

The idea of income transfers also applies to corporate income. Corporations (i.e., businesses of all types) are responsible for taxes on the profits they earn from all of their operations and investments. No oil-depletion allowances, equipment depreciations, or other such tax dodges are allowed by this proposal. What constitutes profit and what is or is not a valid business expense are details for accountants to work out. However, corporations can transfer part of their income to stockholders as dividends, to partners, to non-profits as donations, to employees as bonuses, awards, and benefit contributions, and to retirees as pension benefits.

Large corporations are typically not monolithic; they often consist of a holding company and one or more subsidiaries. How should such a structure be taxed? As a single entity, as separate corporations, or as a "family" in which income can be transferred among members? The last possibility is intriguing in that it would enhance the capitalization of the company's subsidiaries, the places where growth is most likely to occur. Rules would be needed to prevent the creation of dummy subsidiaries that produce no real goods or services. These possibilities all need to be examined in the face of progressive income taxation, as described later in this proposal.

The results of this approach to corporate taxation are:

* The double taxation of corporate profits and dividends is eliminated. It is simply income to whomever ultimately receives it as income.
* The essential unfairness of different tax rates for dividends versus earned income is eliminated.
* There is a strong incentive for corporations to pay reasonable dividends, to capitalize subsidiaries, and to support non-profits.

**Transfers to Non-profit Organizations**

In this proposal, non-profit organizations are considered the same as service-oriented businesses. They are responsible for taxes on all the income they receive from all of their contributors, excluding operational expenses similar to what service businesses would incur. They can further transfer their net income to secondary recipients, in effect, acting as transfer agents with no tax responsibility for the amounts they receive and then transfer. Of course, they have to pay taxes on net income not transferred. The details of what constitutes an operational expense and what is considered a secondary transfer are left to accountants and legislators to determine.

**Limitations on Transfers**

The primary limitation on transfers is that there can be no *quid pro quo* involved in any transfer; that is, no value received for a transfer. This is what distinguishes transfers from expenses. Nor can there be reciprocal transfers from whom the donor can extract an advantage, monetary or otherwise. For example, the CEO of a corporation should not be able to transfer a portion of his income to a corporation so it can purchase a jet as a perquisite for CEO personal travel. Such attempts to game the system should be prosecuted as tax fraud.

Given the ability to transfer income, there is no longer any motivation to classify organizations as *non-profit*, *tax-exempt*, *religious*, *political*, or *charitable*, or to give them any special tax treatment. The nature of the receiving organization is no longer a factor. People and businesses should be free to transfer their income however they want; thereby eliminating all concerns for such abstractions as "separation of church and state" (which today's tax system grossly violates) and all limitations related to political and lobbying organizations. There is also no need for special reporting of who gave how much to political candidates, since this proposal requires that all transfers be reported as a matter of public record.

**Asset Transfers**

How about profits from the sale of assets? Assets are anything that can possibly generate income, things like real estate, stocks, bonds, mutual funds, savings accounts, farms, real estate, and businesses. We want people to become rich in assets and part of the so called "ownership society." To accomplish this, assets should be freely convertible from one form to another without tax consequences. If I sell my house, I should not have to count the proceeds as income, unless I fail to reinvest, within a fixed period of time, in other assets — the same if I sell my farm and reinvest in mutual funds or a condo in Florida. There should be no distinctions made concerning types of assets. This includes increases in asset values, but not the interest or dividends the assets produce, which are current income and taxable.

So, when do increases get taxed? It's simple; when assets are sold and taken as income instead of being reinvested within a fixed period of time. For example, if a block of stocks bought for $10,000 is sold for $15,000, the profit of $5,000 is taxable income unless the full $15,000 is reinvested in some other asset. Any part of the proceeds not reinvested is income, which can be transferred or allowed to be taxed. How that $5,000 of income is spent doesn't matter: to pay for simple living expenses, to pay for a vacation, a car, or a boat, or even to pay education or medical bills (none of which are assets in the sense intended here).

What about losses from the sale of assets? Investments always involve risk; the amount of perceived risk determines an investment's potential returns. It is not the responsibility of government to reduce the risk of any investment or to otherwise insure against investment losses. Any attempt to do so distorts the market's perception of an asset's level of risk and therefore of its value. If a property bought for $100,000 is sold for $75,000 because that is all the market will bear, the loss of $25,000 should be borne completely by the investor. This eliminates today's tax dodges for mitigating investment gains through offsetting losses. Money losing investments, such as hobby farms or movie productions, can still be bought for other reasons, but not for their ability to offset other investment gains.

Assets should also be transferable from one individual or business to another without any tax consequences. For example, a parent should be able to transfer a family business, all or in part, to a child without the transfer being viewed as a taxable transaction. And the same goes for the transfer of assets to charities or to anyone else, except as payment for services rendered or goods purchased. This gives everyone the ability to do what the rich have always done with their various foundations. Of course, if an asset is sold by the receiver, the proceeds become income for the receiver unless immediately reinvested or transferred. However, here also, asset transfers cannot be reciprocal.

There are three fallouts of this ability to freely transfer assets:

1. Gift Taxes are eliminated since gifts are simply transfers of income or assets.
2. Estate Taxes, the so-called "death taxes," are eliminated. Asset transfers can simply be a provision of a last will. Income received by beneficiaries is taxed the same as any other income, with the same provisions for transfers, including transfers to the future via IRAs.
3. The special treatment of Capital Gains and Losses is eliminated since net gains not reinvested are taxed like any other income.

**Taxation**

So far, this proposal has simplified the taxation of income by making all income (personal and corporate) equivalent, by eliminating all the ways in which income can be excluded from taxation, and by subsuming taxation for Social Security and Medicare within the income tax. It has also introduced income and asset transfers as a way to significantly reduce taxes. Great, but enough taxes to pay for government operations (including Social Security and Medicare benefits) must still be collected. Again, it is not the purpose of this proposal to reduce the size of government, only to make taxation simple, fair, and less intrusive in people's lives.

Many people ask why income taxes should be progressive. Aside from the notion that the rich should pay a higher percentage of their income than the poor because they receive disproportionately more value from living in a modern society, progressive taxation is an incentive for individuals to transfer income to their favorite causes. One does these things, in part, in order to obtain a lower tax rate. At high income levels, one also does them to obtain influence over the people and organizations who receive the transfers. This proposal is not about altruism; transfers give individuals a voice in how and by whom their excess income is spent — charitable, social, political, artistic, scientific, educational, religious, etc. And perhaps more importantly, it provides the opportunity to attach their names to the buildings, academic chairs, foundations, and other institutions they finance.

The more that income and asset transfers finance private community organizations, the less need there is for the government to be involved and the smaller government can become. What if NASA was spun off as a private, scientific organization and financed solely by transfers from individuals and corporations? We'd be on Mars in no time flat. The more that schools and hospitals are financed via transfers, the less need there is for publicly financed schools and hospitals. And the more the needs of the poor are privately financed, the less need there is for government welfare programs. Take this idea to extremes and government's role can be reduced to setting and enforcing standards, rather than actually providing services.

**Tax Rates**

Progressive taxation means that at every income level higher incomes are taxed at higher rates. How can this be achieved when the range of individual and corporate incomes spans more than 11 orders of magnitude, from $0 of income to more than $100 Billion? Today's graduated income tax is defined by a fixed number of tax brackets that make tax rates somewhat, but not very, progressive. Reducing the number of tax brackets, as President Ronald Reagan did, simplified nothing; it reduced the top rate for the wealthy, increased everyone else's tax burden and increased the national debt. Brackets may have been necessary to reduce the complexity of tax calculations in an earlier age, but today we have computers, so it is no great problem to plug an income amount (the sum of all incomes minus all transfers) into a formula and thereby determine one's tax bill. No elaborate tax tables or tax brackets are needed. A single mathematical formula can be used to calculate everyone's taxes. It should be known to everyone and applicable to everyone, including corporations and non-profits — no exceptions.

**Taxation by Formula**

Applying a straight-line formula to tax calculation, we have

Tax = Rate × Income - Offset

where **Rate** is a tax rate and **Offset** is a dollar value. **Rate** and **Offset** must be set at values that will raise enough money for government operations.

A flat tax, in which everyone pays the same rate minus the same offset, is inherently regressive because it taxes the poor at a rate they cannot afford and the rich at a rate they can effectively ignore. But if **Rate** and **Offset** are each a function of income, then more progressive taxation formulas are also possible.

The formula proposed herein progressively spans 12 orders of magnitude of income, from $0 to $1 Trillion. For every extra dollar of income, the tax rate increases by a decreasingly small amount. Low incomes are taxed at low rates and high incomes are taxed at higher rates. This proposal has arbitrarily selected a high income of $1 Trillion to be taxed at 100% because there are no individuals or corporations with an income anywhere near that high. Even at $1 Trillion, the proposal is not confiscatory because it allows income to be transferred to other individuals and organizations.

The following formula may seem complicated, but there are only two variables, total income, and wages.

Tax = (k × Rate × Income) - Offset

where Rate = 1.059463log(income) - 1

and Offset is a function of wages,

as described below.

**Rate**

Rate climbs in a gentle curve as a function of income, from 0% at $0 to 100% at $1 Trillion. This is an **ideal** tax curve since no one is actually taxed at these rates because of income transfers and population distribution factors.

Where does the number 1.059463 come from?

Rate = xlog(income) - 1

If Rate = 100% (i.e., 1) and the

logarithm of 1 Trillion is 12,

 1 = x12 - 1

 2 = x12

 x = the 12th root of 2

 x = 1.059463

Thus, for any income

between $0 and $1 Trillion,

Rate = (1.059463log(income) - 1)

**k**

**k** is a constant determined by an algorithm that forces taxation to equal proposed government spending. The value of **k** in this formula is the magic ingredient that makes this proposal work. An initial value of **k** is selected, everyone's tax bill is calculated, and the results are summed to see if this revenue matches the proposed spending. If the result does not match the spending, then a higher or lower value of **k** is selected, and the process repeats until there is a match. Actually, it is more convenient to calculate taxes in terms of ranges of income (from $60,000 to $70,000) and the average income of individuals in that range.

**Offset**

The initial assumption of this proposal was that offset should be the same for all individuals at all income levels, but offsetting the taxes on higher incomes, where it is not needed, increases everyone's taxes. The solution is to set a limit on incomes whose taxes can be offset; that is, only when income is below a fixed amount would taxes be offset. In other words, offset should be a function of wages.

In the current income tax system, a special credit, the Earned Income Tax Credit (EITC), is available to low-income families that work but still need help with living expenses. The EITC is based solely on household earned income (wages, salaries, tips, commissions, etc.), thereby incentivizing people to work. The EITC increases to a fixed limit, stays at a plateau until a fixed income is reached, and then gradually decreases to $0. Complicating matters, the EITC depends on whether the taxpayer is single or the head of a household and on whether there are 0, 1, 2, or 3 or more children in the household.



In this proposal, however, all income taxes are on individuals, including children, not households. A household's total income can be transferred among its members, however they wish, to determine the taxable income of each. The result is that an **Income Offset (EIO)** can be calculated for each member. Only a single EIO formula is thus needed, and it can be automatically applied to all individuals, and even to small businesses.

For individuals with low wages, when the **Earned Income Offset** is greater than 0, the calculated tax can be less than $0. This is a refund to the individual from the government of the calculated amount — a negative income tax.

**Alternative Minimum Tax**

Wealthy individuals are currently able to use a wide variety of deductions and credits to avoid paying income taxes. An Alternative Minimum Tax (AMT) is calculated for individuals with high incomes. The individual must then pay the greater of the regular income tax or the AMT. This provision was enacted to ensure that they pay something. Originally, only the very rich were subject to the AMT, but because of inflation, large numbers of middle-income people are also afflicted by it.

This proposal abolishes the AMT because it is not needed. First, without any deductions, credits, exemptions or allowances the rich have far fewer opportunities to avoid taxes. Second, all individuals are able to transfer a portion of their income to future years via IRA-like investments. And third, even though individuals are able to transfer income to other individuals, even to an income of $0, in this proposal all income is ultimately taxed at the rate of the final consumer of the income. In this sense, this is a proposal for a consumption tax, a much more comprehensive consumption tax than any number of sales or luxury taxes would be.

**The Budget**

This proposal is not about constraining or reducing the size of government; it is about financing government in a way that is simple, fair, and understandable to everyone. The ideas in this proposal lock down the taxation side of the account books while leaving the spending side open to legislative prerogatives. But clearly, there has to be a relationship between revenue and expenses. It is the lack of such a relationship that has gotten the United States so deeply in debt. A final requirement of a reformed income tax system is that except for real emergencies the government must collect enough in taxes every year to pay its obligations — and hopefully pay off part of the national debt!

If all income taxes are calculated using a single formula, such as the formula proposed herein, this is an easy thing to do. Budgeting determines a bottom-line spending amount, the value of the offset parameters would be determined by Congress, and the Internal Revenue Service would provide statistics on income distribution across the population of people, corporations, and other organizations. We now have supercomputers that can simulate a nuclear explosion, so it should not be that difficult to algorithmically seek a value of **k** that generates enough income to pay the government's bills. This makes taxation automatically based on a proposed amount of spending, a clear relationship understandable to everyone; the more government spends, the higher taxes must be; the less government spends, the lower taxes can be.

But wouldn't this just encourage unlimited government spending? Yes, it would if this were only a single step process. Instead, it must be an integral part of a budgeting cycle that proposes a spending target, considers the necessary values of **k** and the offset parameters, and repeats the cycle until a satisfactory level of spending and taxation is found. With two houses of Congress involved in the process and with the possibility of a presidential veto, it should be possible to keep spending in check. It would also be possible, finally, for citizens (and citizen watch groups) to keep an eye on the process.

**A Spreadsheet Model**

Some of the ideas of this proposal are modeled by a spreadsheet whose primary purpose was to determine the value of **k** under a variety of conditions and parameters. When reviewing the following chart, please bear in mind that the tax rates calculated by the spreadsheet model are based only on 2011 national data for persons, whereas the full proposal includes data for corporations and non-profits. In other words, they are only good enough to illustrate the basic ideas of this proposal. Comprehensive modeling by the IRS or by some other public or private organization is required to validate the ideas of this proposal.

Three variations of the model's parameters are illustrated, which roughly illustrate three tax policies that could be chosen by politicians. In this proposal, these are the only parameters with which politicians and lobbyists can play games. Gone is their ability to manipulate the tax code to favor particular groups. In all cases, keep in mind that the model applies them to the taxes of individuals, not households; after taxes are calculated for each member of a family, they must be added to obtain the family's total taxes.

* The **Low Earned Income Offset** model provides a minimum level of support for low-income individuals.
* The **Medium Earned Income Offset** model is more generous for low income and low-middle income individuals.
* The **High Earned Income Offset** model provides better support for low- and middle-income individuals.

 In the chart following this table, high income individuals pay the most taxes, but in reality, individuals with income between $10,000 and $100,000 produce the most tax revenue because that range is where the bulk of the population exists.

|  |  |  |  |
| --- | --- | --- | --- |
| **Parameters** | **Low Earned Income Offset** | **Medium Earned Income Offset** | **High Earned Income Offset** |
| Offset plateau | $1,000 | $3,000 | $5,000 |
| Plateau limit | $4,000 | $12,000 | $20,000 |
| Phase-out limit | $8,000 | $24,000 | $40,000 |
| Calculated k | 0.61483599 | 0.72713238 | 0.78030667 |

 

**Conclusion**

I am a citizen taxpayer who has been thinking about the current tax system for many years. I believe the combination of ideas in this proposal would be helpful. It is not a "my way or the highway" prescription for income tax reform; rather, it is a "stake in the ground" that can serve as the starting point for much needed discussion. Some of its ideas are libertarian, some are conservative, and some are liberal; it is by combining them that I believe we can best reform our income tax system, make it simpler, fairer for everyone, and more just.

**Summary of the Proposal**

* 1. All income is taxed in a uniform way. All distinctions between wages, dividends, capital gains or any other type of income are eliminated.
	2. Wage taxes are eliminated; Social Security and Medicare are funded through the income tax system.
	3. All deductions, credits, allowances, exclusions, and rebates are eliminated.
	4. Every individual—from infants to mega-corporations-- is responsible for taxes on his own income.
	5. Any individual or organization can transfer any amount of his own income to any other individual or organization without tax consequences. The Gift tax is eliminated.
	6. All transfers of income and assets are reported when filing income tax returns. All such returns by all individuals and organizations are available online to the public.
	7. The Alternative Minimum Tax is abolished.
	8. The "tax-exempt" status of all organizations is revoked. There is no need for this special status.
	9. Corporations pay no taxes on dividends or bonuses transferred to employees, stockholders, or partners. The double taxation of dividends is eliminated.
	10. Income can be transferred to future years by means of IRA-style investments.
	11. Assets can be freely convertible from one form to another without tax consequences. Capital gains not reinvested are taxed as income.
	12. Assets can be transferred from one individual to another without any tax consequences. The Estate tax is eliminated.
	13. All income (both individual and organizational) is taxed at a rate determined by a single progressive mathematical formula. Tax brackets and tax tables are eliminated.
	14. The government must collect enough in taxes every year to pay its obligations and to pay off part of the national debt.
	15. Taxation is automatically linked to total spending by an iterative budget process.